CHAPTER 25

LAND AND BUILDINGS: OPTION TO TAX

25.1 Introduction

Exempt supplies of land and buildings often cause problems due to the fact that any input tax related to that exempt supply is irrecoverable. VATA 1994, s. 26

Whenever there is an exempt supply of commercial land or buildings, the trader has the option of changing the liability of the supply to standard-rated. This is called the "**option to tax**". Schedule 10, VAT Act 1994 has been rewritten with effect from 1 June 2008. Many of the main points concerning the option to tax remain unchanged but there have been changes in some areas. VATA 1994, Sch 10

The option **allows the trader to choose** to eliminate the exempt supply and instead opt to turn **it into a standard-rated taxable supply**. Once opted, any related input tax can be recovered in full because the supply being made is now a taxable supply.

Once the option is made, it will **apply to all future supplies** that are then made in respect of that building by that taxable person. There are certain specific circumstances in which the option can be revoked.

The option is made on a **building-by-building basis**. This means that if an owner of several different buildings wants to make an option to tax, he can choose to make the option over some buildings and not others - it is entirely at his discretion. From 1 June 2008 it is possible for a person to make a Real Estate Election (REE). This means that every property in which he has an interest is treated as opted. There is then no need to opt to tax properties individually but the option can be revoked on individual properties if the conditions are met. VATA 1994, Sch 10 Para 21 and 22

However, if the buildings are **linked internally or by a covered walkway**, or comprise of a **number of units** around a fully enclosed concourse, they are **regarded as a single building** for this purpose. VATA 1994, Sch 10 Para 18

From 1 June 2008 if a taxable person opts to tax bare land and later constructs a property on the land, that building is covered by the original option. This is a significant change to HMRC's earlier policy, but to allow some flexibility a new building can be permanently excluded from the effects of the option provided all the relevant conditions are met.

The option to tax is a useful planning tool – it can change the status of a supply in such a way that a trader can protect himself from suffering irrecoverable input tax.

Illustration 1

Mr Jones owns an office block in Stockport, which is currently let out to two tenants, an insurance company and a firm of accountants.

Since Mr Jones is **letting-out** a commercial property, he is making exempt supplies within Schedule 9, Group 1.

The building needs some renovation, costing £500,000 plus VAT. Renovating and building services are standard-rated supplies, so VAT will be charged to Mr Jones on these costs.

Because Mr Jones leases the building and hence makes an exempt supply, the £87,500 of input tax on the renovation costs will relate to the exempt supply of that office block and will be irrecoverable.

If Mr Jones were to opt to tax the building, he will then be making a taxable supply. Thus, when the renovation occurs, the £87,500 of input tax he pays will relate to a taxable supply and hence will be recoverable in full.

Illustration 2

Continuing with the above illustration, now consider what is going to happen in the future.

The option to tax means that any future supply Mr Jones makes in connection with the office block will be a **standard-rated supply**. The next time he sends an invoice for rent to his tenants, he will have to add 17.5% VAT on top.

For the tenants, they will suddenly receive an invoice for rent that has gone up by 17.5%.

One of those tenants is an accountant; accountants make taxable supplies. Therefore, the extra 17.5% is input tax for the accountant and because the accountant makes taxable supplies, the input tax is recoverable in full. The most that the accountant tenant will "suffer" from the 17.5% increase is a cashflow disadvantage.

The other tenant is an insurance company, which makes exempt supplies. When the rent goes up by 17.5%, that increase is input tax which is irrecoverable as it relates to exempt supplies. This will be a direct cost to the insurance company and there is nothing they can do about it.

When the landlord makes an option to tax, he does not have to seek permission from his tenants before doing so. However, the landlord should check the lease agreement because **some lease agreements do not allow the option to tax to be made** or do not allow the rent to be increased (even by VAT). In such cases, the irrecoverable VAT must be met out of the rental profits for the landlord.

If the lease agreement is silent, the landlord can make an option to tax without any permission being given by the tenants.

Example 1

Consider each of these five supplies and decide whether the option to tax can be made on the supply.

		Tick
1.	Sale of land	☐
2.	Sale of a 50 year old terraced house	☐
3.	Lease of a 5 year old factory	☐
4.	Freehold sale of a 1 year old office block	☐
5.	99 year lease of a 1 year old shop	☐

25.2 Revocable Election?

One of the changes introduced by the rewrite of Schedule 10 of the VAT Act 1994, is the circumstances in which the option to tax be revoked.

The option to tax can be revoked in three situations.

1) The option **can be revoked within the first six months** after making it, provided that no supplies have been made which are affected by the option. The new legislation makes it clear that any input tax repayable as a result of this change from taxable to exempt supplies must be repaid.

   One of the specific conditions for revoking the option, at para 23(1)(b) of Schedule 10 is that the taxpayer has not used the land since the option had effect. It has become apparent that a small number of businesses are **unable to revoke their options** because they were **already in occupation of the building when they opted to tax. From 1 April 2010 this part of the legislation has been repealed** (para 23(1)(b)). The business must **meet one of three conditions** to be able to revoke the **option, but this is less onerous than before.** VATA 1994, Sch 10 Paras 23 to 25

2) Where no interest has been held in the property for over 6 years.

3) The option can be revoked **20 years after it was made**.

The Government introduced the option to tax supplies of commercial property with effect from 1 August 1989; therefore the first options to tax became eligible for revocation in August 2009.

Once an option to tax has been made, it has to be **notified to HMRC within 30 days of being made.** If a property is currently being let out on an exempt basis, HMRC's permission will be required before the option to tax can be made, unless the conditions for automatic permission are met.

25.3 Supplies not affected by the option

There are some supplies which an option to tax does not affect and which remain exempt, even though the option has been exercised on the property in question. VATA 1994, Sch 10 Paras 5 to 11

These are as follows.

(*a*) **Dwellings, etc**. Any grant in relation to a building or part of a building if the building or part of the building is designed or adapted, and is intended, for use as a dwelling or a number of dwellings or solely for a relevant residential purpose.

The most common example would be a shop with a flat above it where an option to tax would make any rent from the shop standard-rated but any rent from the flat would remain exempt.

(*b*) **Dwellings conversions.** Any grant made to a person (the recipient) in relation to a building or part of a building if the recipient certifies that the building or part of the building is intended, for use as a dwelling or a number of dwellings or solely for a relevant residential purpose. The most common example is where an opted building is sold to a developer who intends to convert the property into dwellings.

It should be noted that if no certificate is provided by the recipient then the option will take full effect.

(*c*) **Charitable use**. A supply in relation to a building intended for use solely for a relevant charitable purpose, other than as an office. Again a certificate must be provided for the option to be disapplied.

(*d*) **Residential caravans**. A supply of a pitch for a residential caravan.

(*e*) **Residential houseboats**. A supply of facilities for the mooring (including anchoring or berthing) of a residential houseboat.

Similar provisions also apply where opted land is bought by a Relevant Housing Association or a DIY Housebuilder.

25.4 Sub-leases

If a landlord makes the option to tax, this will affect all supplies relating to that building – eg, rent charged to existing tenants, any premium or rent charged on a subsequent lease, any proceeds of sale of the freehold, etc.

However, the **landlord's option does not bind someone with a different interest in the land.**

A landlord may opt to tax the lease, which means that the tenant pays VAT on the rent to the landlord. But, **if the tenant sub-leases, then the tenant will have a separate option to tax** the sub-lease. If a tenant does not make his own option to tax, then VAT paid to the head landlord will thus become irrecoverable because it relates to the making of the exempt sub-letting. If, however, the tenant does opt to tax then this returns to a taxable supply situation and the input tax is fully recoverable.

Example 2

There are five supplies listed. Decide whether they are standard-rated, zero-rated or exempt and then, if it is an exempt supply, decide whether the option to tax can be made in respect of that supply.

		S.R	Z.R	Exempt	Option to tax
1.	Freehold sale of 2 year old factory	☐	☐	☐	☐
2.	Grant of a 21 year lease in a brand new office block	☐	☐	☐	☐
3.	A farmer rents out a plot of land to another farmer	☐	☐	☐	☐
4.	A landlord leases out 2 floors of a building to an insurance company tenant	☐	☐	☐	☐
5.	A landlord leases out a flat in a brand new luxury development for 5 years to Mr Smith	☐	☐	☐	☐

Answer 1

		Tick
1.	Sale of land	✓
2.	Sale of a 50 year old terraced house	X
3.	Lease of a 5 year old factory	✓
4.	Freehold sale of a 1 year old office block	X
5.	99 year lease of a 1 year old shop	✓

The sale of land is an **exempt** supply and the option to tax **can** be made on this supply.

The sale of a 50 year old terrace house is an **exempt** supply, but it is a domestic building rather than a commercial building, so the option to tax **cannot** be made.

The lease of a 5 year old factory is an **exempt** supply – because it is a commercial building, the option to tax **can** be made.

The freehold sale of a 1 year old office block – the sale of a new, commercial freehold is a **standard rated** supply. It is not exempt so the option to tax **does not apply**.

A 99 year lease on a 1 year old shop – this is not the sale of a new commercial freehold, so it is an **exempt supply**. The option to tax **can** therefore be made.

Answer 2

		S.R	Z.R	Exempt	Option to tax
1.	Freehold sale of 2 year old factory	✓	X	X	X
2.	Grant of a 21 year lease in a brand new office block	X	X	✓	✓
3.	A farmer rents out a plot of land to another farmer	X	X	✓	✓
4.	A landlord leases out 2 floors of a building to an insurance company tenant	X	X	✓	✓
5.	A landlord leases out a flat in a brand new luxury development for 5 years to Mr Smith	X	X	✓	X

The freehold sale of a two-year-old factory is freehold, new and commercial and hence a **standard-rated** supply.

The grant of a 21-year lease in a brand new office block is an **exempt supply**. As it is an exempt supply of a commercial building, the option to tax **can** be made.

A farmer rents out a plot of land to another farmer; renting out the land is an **exempt supply**. The option to tax **can** be made because it can be made over an exempt supply of any sort of land.

A landlord leases out two floors of a building to an insurance company – it is a lease, it is a commercial building so it is an **exempt** supply. The exempt supply of a commercial building means the option to tax **can** be made.

A landlord leases out a flat in a brand new luxury development for 5 years to Mr Smith. It is a lease but it is domestic property, so it is an **exempt** supply. Zero-rating does not apply as no major interest has been granted.

However an exempt supply over domestic property means that the option to tax **cannot** be made.